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TREASURY FOR U/S TAYLOR AND OASIA - MILLS
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SUBJECT: TURKEY'S ECONOMY APRIL 10: MARKETS DROP ON NO.

IRAQ/U.S. AID CONCERNS; OZTRAK FIRING; DERSIS ON THE ECONOMY

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Markets Worry About No. Iraq/U.S. Aid,
Ignore Positive Trends out of Lack of Trust

1. (U) As of 2:00 pm local time April 10, local news reports that Iraqi Kurds have taken Kirkuk are raising market concerns of a Turkish reaction that could jeopardize the U.S. aid package. T-bill yields rose nearly three percentage points to 66 percent; the lira depreciated almost two percent to TL 1,670,000; the Istanbul Stock Exchange dropped 6.6 percent.

2. The main concern, per our market contacts, is the ongoing story about an explicit northern Iraq condition in the Senate to U.S. aid. Other negative developments, less critical to sentiment but also cited by market contacts, are the firing of Treasury U/S Oztrak, and telecom company ARIA (a major foreign investor, see below) filing an international arbitration claim against the GOT.

3. (SBU) Comment: Market contacts express two concerns on northern Iraq: the GOT for face reasons might be forced to reject an explicit Iraq condition; the Turkish military might actually intervene whether or not there's any explicit condition. In either case, the concern is that Turkey would miss out on \$8.5 billion and otherwise further damage the U.S. relationship.

4. (SBU) Comment continued: Today's market declines do not reflect some recent positive developments: the IMF Fourth Review is next week; the GOT passed a strong budget and froze discretionary spending; the war appears to be winding down and oil prices are declining; The U.S. is poised to offer \$8.5 billion in concessional long-term loans. As market analyst Murat Ucer told us, "local markets don't like anything this government does." He and others see a very high continuing program implementation risk that can only be addressed over months of strict carrying out of reform commitments. End Comments.

Babacan Confirms Oztrak to Be Replaced;
Oztrak Says Leaving April 19

5. (U) Early on April 10, before heading to Washington for Fund/Bank meetings, MinState in charge of Treasury Babacan confirmed to local press rumors that Treasury U/S Oztrak would be replaced shortly. In his April 10 column, Hurriyet newspaper's Erdal Saglam (a friend of Oztrak's from college) wrote that Oztrak plans to resign on April 19, the day after the IMF Board review. Oztrak's likely replacement is Mesut Pektas, a former Finance Ministry inspector and Istanbul Municipality official in charge of finances.

Dervis on the Economy - Focus on
Social Issues, Still an Outsider

6. (SBU) On April 10, we met with opposition CHP member of parliament (and former State Minister in charge of Treasury) Kemal Dervis. His main observations on the economy follow:

-- The only way to fundamentally change economic reform dynamics in Turkey is through foreign direct investment (FDI), a minimum of \$5-6 billion is required to ensure medium-term stability. FDI requires two things: internal bureaucratic reforms; an anchor in the EU, meaning a clear accession path. Without such inflows, Turkey will see only marginal improvements that can be quickly erased through reform backsliding.

-- Comment: Dervis is one of many chanting the "we need foreign direct investment" mantra, to no discernible practical effect on the investment climate. Turkey's climate is not improving. For example, the country's third largest GSM operator Aria (a 50/50 joint venture between Isbank and Telecom Italia, making it one of the largest foreign investors) this week filed an international arbitration claim against the GOT for not honoring the GSM license agreement.

-- Dervis had little comment on Turkey's fragile debt dynamics. He sees a "muddle through" scenario working. Turkish banks are liquid, and making good returns at current high rates, and have an interest in working with Treasury to roll-over domestic debt. Improving debt dynamics beyond that will require strong growth, continuing high primary surpluses, and careful debt management.

-- He is more concerned about "social sustainability" than debt sustainability. While Turkey's official unemployment rates, 11-12 percent, are not unusual by European standards, there is practically no social safety net in Turkey. Unemployed Europeans get 80 percent of their salaries, whereas unemployed Turks get only six months of benefits.

-- Personnel changes in economic team worry him. It's key to market confidence to have an economic team, especially at Treasury, that projects sincere belief in the reform program. Gul as PM understood this, and supported Oztrak's team. Erdogan, however, is putting "hard core partisans" in key technocrat positions. Dervis also sees "bad body language" when Erdogan talks about reform, sending a message of "I don't really believe this" which is not helpful to market morale.

17. (SBU) Comment: Dervis, after two years immersed in Turkish politics, still comes across as an outsider, not comfortable with the need to fight his way up the ranks of Turkish politics. He told us he is going on a speaking tour of seven Turkish universities, but we didn't hear any passion for speaking out. He also had little to say on debt or other macro-economic issues, without Treasury hands like Faik Oztrak around. He was more eager to discuss traditional World Bank-type social and sectoral issues.

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